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DIRECTORATE OF INTELLIGENCE

Intelligence Memorandum

The Economic Situation In Pakistan

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CENTRAL INTELLIGENCE AGENCY
Directorate of Intelligence
June 1971

INTELLIGENCE MEMORANDUM

THE ECONOMIC SITUATION IN PAKISTAN

Introduction

1. Even before the civil war began in late March, Islamabad already faced serious economic problems. Production and exports were stagnating, yet purchases from abroad continued to increase rapidly. As a result, Pakistan's foreign exchange reserves fell by 50% during the year ending February 1971. Moreover, prices of essential commodities had risen sharply, unemployment remained high, and continuing political uncertainty had eroded investor confidence.

2. The civil war brought the East Wing's economy to a virtual standstill and simultaneously increased expenditures and reduced financial inflows in the West Wing. This memorandum examines Pakistan's economic situation in 1970, the economic effects of the civil war, and short-term prospects for the economy.

The Economy on the Eve of the Civil War

3. In early 1971 there were signs of weakness throughout Pakistan's economy, and the short-term outlook was gloomy. The balance-of-payments situation was especially acute, as foreign exchange reserves had fallen from \$346 million in February 1970 to \$170 million in February 1971. On the domestic scene, agricultural prospects were dim, industry was operating well below capacity, and the government's budget deficit was widening. There were mounting pressures from the World Bank and other sources for devaluing the currency. At the same time, political uncertainty was eroding investor confidence, and a series of natural disasters -- floods and cyclones in the East Wing, and a drought in the West Wing -- foreshadowed a poor crop year.

Note: This memorandum was prepared by the Office of Economic Research and coordinated within CIA.

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4. Pakistan's trade deficit widened to $429 million in 1970 from $323 million in 1969, as exports grew by only 3% and imports by 16.5%. Exports had increased at an annual rate of more than 6% in 1960-69. The disappointing export picture reflected a decline in earnings from raw cotton and jute resulting from slower growth in cash crop production, increased domestic consumption for industrial purposes, and increasing competition in foreign markets from synthetic fibers. In mid-1970 the government attempted to boost jute production by raising price supports for farmers, and to increase exports of all primary products by offering a 10% bonus to traders. The bonus for jute, however, merely offset the cost increase brought on by the increased price support for growers. In any event, the export effort met with little immediate success.

5. The sharp growth in imports in 1970 was concentrated in foodgrains, chemicals (including fertilizers), and edible oils. A large share of these imports was subsidized by foreign aid, but even if subsidized items are excluded from consideration, the trade deficit still increased substantially over earlier years. The increased food imports reflected greater needs in East Pakistan resulting from disastrous weather conditions, as well as receipts of delayed deliveries in the first half of the year. Other import increases reflect an apparently selective liberalization of import restrictions – easier credit terms and increased availability of foreign exchange – in the beginning of the year. The import statistics also probably included some capital flight as importers overinvoiced to receive larger foreign exchange advances from government lending institutions. Import controls were tightened in July 1970, and further restrictions as well as credit controls were applied in early 1971; however, imports continued to increase at a rapid rate through February.

6. Inflows of private transfers, predominantly remittances from Pakistanis living abroad, apparently declined in the last half of 1970, also contributing to the foreign exchange drawdown. Only about $32 million reportedly was received in that period, compared with $47 million in the first half of the year and $57 million in the last half of 1969. This probably reflected anticipation of devaluation and the general political uncertainty.

7. The foreign aid flow in 1970 apparently was about the same as the previous year – about $450 million. The decline in grant aid in recent years and the increasingly hard terms demanded by foreign creditors have resulted in a debt service burden which has grown much faster than foreign exchange receipts from goods and services and private transfers.

8. Rumors of devaluation gained increasingly wider circulation in early 1971, but no action was taken. Pakistan has been under pressure for several years, especially from the International Monetary Fund, to devalue

the rupee. The pressures arose not only because of continuing difficulties with the balance of payments, but also because of the misallocation of foreign exchange resources resulting from the complicated multiple rate system used in foreign trade.

9. While Pakistan's foreign exchange position was deteriorating, agricultural output in the 1971 crop year (July 1970-June 1971) was expected to increase only 2.3% compared with an average growth of almost 4% during the 1960s. In the East Wing the rice crop was expected to be several hundred thousand tons below the previous year's level of 11.8 million tons because of cyclone and flood damage during 1970. Some 2.5-3.0 million tons of foodgrain would be needed from outside sources to meet consumption requirements. Production of jute – the East's major cash crop – also appeared to be falling short of the previous year's level because of bad weather and low prices.

10. In West Pakistan, a drought was expected to prevent wheat production from showing much if any increase over the 7.1 million tons produced in 1970, and rice production was expected to decline somewhat from the 2.3 million ton 1970 level because of insect infestation. Production of the West's major cash crop, cotton, also appeared to be falling slightly short of the previous year's level and much below the production target because of water shortages during planting and insect infestation during the flowering period.

11. Industrial production reportedly declined between July 1970 and January 1971. The uncertain political atmosphere probably was paramount in depressing private investment and construction activity. Foreign exchange constraints imposed in late 1970 may have slowed the growth of industrial goods imports. There were labor-management strains, and consumer demand for domestic products apparently also had fallen.

12. Pakistan's internal financial situation also had deteriorated considerably in 1970 as government expenditures shot upward. The major factors were relief and rehabilitation costs associated with the floods and cyclone in the East Wing, expenditures on the national election in November, and increased expenditures for farm price supports and commodity stockpiles. Moreover, there was a revenue shortfall in the last six months of 1970, and borrowing from the banking system increased sharply, with the banks' net claims on the government increasing by $200 million, or almost 10%, in the last half of 1970. Credit to the private sector increased by almost $280 million, or about 12%, in the same time frame to accommodate a higher level of imports and possibly to finance capital flight. The money supply increased by 12.5%, and the inter-bank interest rates climbed from 5-1/2 to 8-1/2 in the twelve months preceding the civil

war. The credit expansion, higher prices of some imported goods, and supply shortages led to substantial price increases. Prices of basic necessities rose 8%-10% between July 1970 and February 1971. In an effort to cope with its financial problems, Islamabad announced new taxes in January 1971, most important a 10% surcharge on individual and company incomes above $3,800 annually. Credit restrictions also were imposed.

Economic Effects of the Civil War

13. On 25 March 1971, West Pakistani troops moved into East Pakistan to suppress the separatist-oriented Awami League -- the East's principal political party. The apparently unexpected Bengali resistance prolonged the military action, and fighting spread into the countryside. Western sources attribute about 200,000 deaths to the war in the first two months of fighting. It is still too early to assess the total war costs in terms of property damage, additional military expenditures, and forgone production. The economic disruptions, however, had a snowballing effect that slowed economic activity in both wings, worsened the foreign exchange situation, and dimmed even further the economy's short-term prospects.

14. In the East, rice production has been hindered by disruptions to distribution of seed, fertilizers, and pesticides, and - in some areas - inattention to planting and harvesting. Tea production also has been set back as many West Pakistani and expatriate plantation managers as well as Bengali workers have abandoned tea plantations. Agriculture in East Pakistan today probably has lost most of its few vestiges of modernity and is more dependent on subsistence rice farming than in recent years.

15. The internal distribution of foodstuffs as well as other economic links in the East Wing have been disrupted because of extensive damage to transportation links. About half of the East's rail network was out of service in early May, and the important Dacca-Chittagong link probably will not be in operation before July. Some 80% of the roads reportedly were damaged during the fighting. Moreover, transportation equipment has been diverted for military use by the West Pakistani army.

16. Food imports by East Pakistan also were disrupted. Vitally needed foodgrains had to be turned away from Chittagong, the East Pakistani shipping center, first because of the fighting and then because of labor shortages. In early June the port still was operating far below its normal capacity. US PL-480 shipments were temporarily suspended because of the port problems.

17. With industrial labor fleeing to the countryside and much of management returning to the West, manufacturing has been severely cut

back. In early June the jute industry was operating at only about 10% of capacity. The East's only petroleum refinery and the only steel mill were out of production for at least a month during the fighting.

18. In the West, economic activity slowed gradually, primarily because its trade with the East was interrupted. As a result of the civil war, shipments to the East were limited almost exclusively to military supplies and equipment. In any event, the virtual closure of the ports at Chittagong and Chalna, and the general disruption of commercial activity in the East, precluded a continuation of trade relations between the wings. West Pakistan's cotton textile manufacturers lost their major outside market, and some mills were forced to cut back operations sharply. Items normally imported from the East – tea in particular – had to be purchased with scarce foreign exchange from Ceylon and other sources.

19. Islamabad's foreign exchange reserves continued to decline in March and April, and in early May were only about $135 million, barely enough to finance one and one-half month's imports. The drawdown might have continued irrespective of the civil war, but the disruption to trade was clearly a contributing factor. The shutdown of the East's major ports halted exports for two months (jute shipments have slowly been resumed). Earnings from exports of raw jute and jute manufactures had averaged $25 million per month in 1970, and earnings forgone from the civil war thus far in 1971 most likely are irretrievable. The West's exports also have been reduced as some ships have been used for military purposes.

20. Islamabad took steps in May to slow down the drain on its reserves. The government informed all official (other government) creditors that it would not repay debt due in the six-month period May-October 1971 – about $60 million. The move – tantamount to default, although the government promised to pay equivalent amounts into blocked rupee accounts – was made after Western creditors had indicated their reluctance to grant new aid or debt relief in view of the West's actions in the East. At the same time, the government acted to cut back imports. Most imports of consumer manufactured goods were banned through June; increased restrictions, which amounted to a partial devaluation, were imposed on many other items. Apparently as a result of these actions, foreign exchange reserves increased in May.

21. The civil war and the continuing military occupation of East Pakistan are straining the central government's financial resources. Defense expenditures before the crisis were about $600 million annually, or some 35% of the national budget, and were concentrated heavily in the West Wing. The cost of the military occupation of the East Wing [redacted] 25X1
is above

and beyond normal military expenditures. At the same time that military costs have increased sharply, the central government has been virtually cut off from revenue receipts from the East Wing. These revenues have accounted for about $350-$400 million annually in recent years. Reductions in development expenditures, however, especially in the East, probably have largely offset the cutback in revenue receipts.

22. Prices in East Pakistan climbed as shortages developed in essential commodities, and normal commercial activity virtually ceased for two months. As of early June, most commodity prices in Dacca stabilized at about 20%-30% above pre-hostility levels after reaching much higher levels in April and May. The price situation in urban areas would be even worse if a large share of the population had not fled to the country.

Short-Term Prospects

23. Pakistan's economic prospects depend heavily on when and how the current crisis is resolved. A continuation of the military occupation – especially if the Bengalis are able to mount significant guerrilla operations – would place a heavy strain on the central government's limited resources. It would also further delay economic aid commitments, at least from the Western consortium. From a strictly economic point of view, therefore, it would be to the government's advantage to restore normalcy as quickly as possible and to seek out sufficient economic aid to rehabilitate the East as well as to resume economic development programs in both wings.

24. Irrespective of the timing and nature of the civil war's end, short-term prospects are bleak for both wings. The food situation in East Pakistan may get worse before it gets better. By the time the ports are in position to resume near-regular operations, the monsoon season will be in full force, adding to internal distribution difficulties. Islamabad has taken few effective steps to cope with the crisis. If, in fact, distribution cannot be measurably improved in the next few months, widespread food shortages may result in the East. Next to the cyclone-hit areas, the normally rice-deficit urban and jute-growing areas are the most likely candidates to face famine conditions in the next few months.

25. Crops will also suffer from the civil war, with US AID estimating a possible 10% drop in production of the East Wing's rice crop to be harvested next fall. This crop normally accounts for about one-quarter of the total annual rice harvest. Thus the East Wing's dependence on external food support may well increase in 1972 – Islamabad has tentatively set the East's food import requirement for the 1972 crop year at 2 million tons – even if good weather prevails.

26. No imminent recovery is anticipated in the industrial sector in either wing. In the East, much of the labor force may decide to stay away from the plants both in fear of the West Pakistani occupying force and to be closer to the rice crop. In the best of times, 40%-60% of the industrial labor force moves back and forth between farm jobs and industry. There are indications that Islamabad is considering closing some plants which are operating far below capacity in order to allocate personnel and equipment to other facilities. Moreover, the foreign exchange shortage and distribution problem will inhibit imports of industrial parts and movement of finished goods from the plants. Production of jute manufactures will, of course, suffer from any cutback in raw jute output. Finally, much West Pakistani capital and expertise may have left the East for good, although businessmen in the West are now being encouraged to fill the vacuum in the East. Certainly industrial production in East Pakistan – which accounts for over one-fourth of the value of industrial production in all Pakistan – will show a sharp decline in 1971, and prospects for a return to 1970 levels anytime in the near future are dim.

27. West Pakistani industry will continue to be plagued not only by lost markets in the East but also by shortages of imported raw materials and intermediate goods resulting from the unavailability of foreign exchange. A decline in output appears likely in 1971, with future growth depending on restoring East Pakistani markets and expanding foreign markets.

28. Military occupation costs incurred in the East will probably mean continued budget deficits even if unpopular new taxes are imposed and there are further reductions in development spending (and perhaps social services). [redacted] 25X1 Rising prices and a general economic depression will probably also continue to coexist. Islamabad will undoubtedly officially proclaim some type of new economic deal for the East Wing in order to obtain foreign assistance, but given the attitudes of the West Pakistani leadership it is unlikely that the East will actually receive a significant increase in its share of government funding in the near term.

29. If the drain on foreign reserves resumes despite recent actions to conserve foreign exchange holdings, the government can either further restrict imports, extend the debt moratorium, turn to a substantial devaluation of the rupee, or some combination of these. The main burden of import restrictions falls on West Pakistani industry, and, for socio-political reasons, the government may be reluctant to depress this sector much more. Another default on debt will further estrange existing and potential creditors. The success of any devaluation will be restricted by such constraints on exports from the East Wing as a probable drop in jute output, a continuing contraction in external jute markets, and internal distribution

problems. Any meaningful devaluation from the official rate will have to be substantial because Pakistan's current trade system already has produced effective rates of exchange varying up to 14 rupees per dollar as opposed to the official rate of 4.76 rupees.

30. Pakistan's leaders have asked Communist China to meet some of their needs. Pakistan reportedly requested that Peking make available $150 million in commodity aid in the near future. China responded with an offer of $20 million in new aid in addition to $200 million in economic aid promised in November. This latter offer originally was to have been mainly project aid spread over a long time period. [redacted] 25X1

31. The Western nations have indicated that Islamabad will have to return conditions to normal in the East, develop a massive assistance program for the East, reduce spending on foreign military purchases, and institute fiscal and exchange reforms if it hopes to receive new assistance from the consortium. There have been virtually no new aid commitments by Western nations since March, and total commitments by Western donors in the 12 months ending in June 1971 apparently will reach only about $130 million compared with $416 million in the previous 12 months. The full impact of the reduced commitments, however, will not be felt by Islamabad for at least several months, inasmuch as non-project aid in the pipeline still remains substantial. The USSR has also shown little sympathy for Islamabad's military action in the East and is a doubtful source of important new commitments. The rich Arab countries might offer some nominal assistance, however, out of feelings of Moslem solidarity.

Conclusions

32. The civil war has had a sharply depressing effect on the already sorely-pressed Pakistani economy. In the East Wing, food distribution and normal commercial activity have been disrupted, and foreign trade and industrial production have come to a standstill. Much of the urban population apparently has returned to subsistence agriculture, and millions of refugees have fled to India. Meanwhile, the West has seen its trade with the East disrupted, internal revenues reduced, and foreign aid donors alienated. At the same time, foreign exchange reserves are low and military expenditures have increased substantially.

33. The short-term economic outlook for both East and West is for more economic woe. Unless large-scale foodgrain imports can be resumed

by the East and distribution problems overcome, widespread famine could develop. There is no indication that the bulk of the East's urban labor force will resume work soon. West Pakistan is faced with the continuing drain on its resources for the military occupation.

34. Prospects for resumption of large-scale foreign aid from the Free World are virtually nil unless Islamabad is able to restore a degree of normalcy in the East. Any new aid will go largely for recovery in the East, with the West having to set aside hopes for resumed growth. A continuation of decreased economic activity in the East and foreign exchange constraints will mean continued depression for many Western traders and manufacturers. All in all, Pakistan appears destined for a prolonged, sharp economic recession, a situation which will seriously affect political stability in both wings.